

January 2010

## SEC Adopts Enhanced Proxy Disclosures

On December 16, 2009, the U.S. Securities and Exchange Commission (SEC) adopted final rules expanding the obligations of public companies to disclose certain information to shareholders through their proxy materials and other reports that they file with the SEC *Securities and Exchange Commission Release Nos. 33-9089; 34-61175* (Dec. 16, 2009) (Final Rules). The Final Rules are similar to the rules that the SEC proposed in July 2009, which were the subject of our prior Client Advisory “Enhanced Proxy Disclosure - SEC Proposals and Recommended Actions.”

The Final Rules require that a company disclose or enhance its disclosure of:

- compensation policies as they relate to risk;
- stock and option compensation awards;
- potential conflicts of interest with regard to compensation consultants;
- director and nominee qualifications and background;
- diversity policies relating to board membership;
- the rationale behind company leadership structure; and
- shareholder voting results on Form 8-K.

The Final Rules are effective for definitive proxy statements filed on or after February 28, 2010 by companies whose fiscal years end on or after December 20, 2009. Accordingly, this Advisory contains certain recommended actions to be taken by public companies in connection with the preparation of their Forms 10-K and proxy statements (*See page 5*).

### Enhanced Compensation and Risk Management Disclosures

The Final Rules amend Item 402 of Regulation S-K to require disclosure by an issuer in its proxy statement of how its compensation policies or practices create incentives that affect risk and how the issuer manages those risks. The disclosure is not limited to policies or practices for executive officers, but is to be made for all employees generally, including non-executive officers. In an important shift from the SEC’s July 2009 proposed rules, the SEC heightened the standard for disclosure from those policies and practices that “may have a material effect on the company” to those policies and practices that “are reasonably likely to have a material adverse effect on the company.” Materiality is determined on a company-specific basis.

Note that the SEC specifically stated that it would **not** expect to see “generic or boilerplate disclosure that the incentives are designed to have a positive effect, or that compensation levels may not be sufficient to attract or retain employees with appropriate skills in order to enable the company to maintain or expand operations.”

The new disclosure requirements will not apply to smaller reporting companies, despite being separate and apart from the Compensation Discussion & Analysis (CD&A).

### Revisions to Stock and Option Disclosure

The Final Rules revise disclosure of stock awards and option awards in both the Summary Compensation Table and Director Compensation Table (collectively, the Tables). The Tables now require disclosure of such awards based on the aggregate grant date fair value in the year of the award, rather than the amount recognized for financial statement reporting purposes computed in compliance with FAS 123R because “it better reflects compensation decisions.”

The Final Rules include special instructions for awards subject to performance conditions. The value of awards subject to performance conditions, as reported, must be computed based upon the probable outcome of the performance condition(s) as of the grant date. If there are multiple performance conditions, the maximum potential value of a performance award must be disclosed in a footnote to the Tables assuming that the highest level of performance condition is probable.

In order to facilitate year-to-year comparisons, registrants providing Item 402 disclosures for a fiscal year ending on or after December 20, 2009 must provide recomputed disclosure for each preceding fiscal year shown in the Tables, so that stock awards and option awards columns present the applicable full grant date fair values. Conforming changes to the total compensation column must be made.

Additionally, if a person who was a named executive officer (NEO) for the most recent fiscal year was also disclosed as an NEO for 2007, but not for 2008, the Final Rules require an issuer to report that NEO's compensation for each of those three fiscal years. However, companies are not required to include different NEOs for any preceding fiscal year based on recomputing total compensation for those years or to amend prior years' Item 402 disclosure in previously filed Forms 10-K or other filings.

### **Compensation Consultant Disclosure**

The Final Rules adopt a modified version of the previously proposed amendments, and require the following disclosure:

- If (i) the board, or a committee of the board, has engaged its own consultant to provide advice on executive and director compensation, (ii) the board's consultant or its affiliates provide other non executive compensation consulting services to the company, and (iii) the aggregate fees for the non executive compensation consulting services exceed \$120,000 during the company's fiscal year, the registrant is required to disclose the aggregate fees paid for all compensation consulting services;
- Whether the decision to engage the compensation consultant or its affiliates for non-executive compensation consulting services was made or recommended by management, and whether the board has approved these non executive compensation consulting services provided by the compensation consultant or its affiliate;
- If the board has not engaged its own consultant, fee disclosures are required if there is a consultant (including its affiliates) providing executive compensation consulting services and non-executive compensation consulting services to the company, provided the fees for the non executive compensation consulting services exceed \$120,000 during the company's fiscal year.

The Final Rules do not require disclosure of:

- Fees and related disclosure for consultants that work with management (whether for only executive compensation consulting services, or for both executive compensation consulting and other non-executive compensation consulting services) where the board has its own consultant; and
- Services involving only broad-based, non-discriminatory plans or the provision of information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant.

### **Enhanced Director and Nominee Qualifications Disclosure; Diversity**

The Final Rules require companies to disclose for each director and director nominee the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director of the company. Disclosure is required for all directors regardless of whether the director is up for reelection and is in addition to the current disclosure requirements that require a discussion of each director's and director nominee's business experience during the past five years.

The Final Rules also require disclosure of any directorships held by each director and director nominee at public companies at any time during the previous five years (as opposed to only current directorships).

The Final Rules do not require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a committee member, as initially proposed. In addition, the Final Rules delete the reference to "risk assessment skills." However, if an individual is chosen to be a director or a nominee to the board because of a particular qualification related to service on a specific committee or if a particular skill, such as risk assessment or financial reporting expertise, was part of the specific experience, qualifications, attributes or skills that led the board to conclude the person should serve as director, such information should be disclosed.

The Final Rules also expand the disclosure of legal proceedings. The Final Rules lengthen the time during which disclosure of certain legal proceedings is required from five to ten years and require disclosure of the following additional legal proceedings:

- Any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity;
- Any judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement to such actions; and
- Any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Finally, although not included in the proposed rules, the SEC will require disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director positions. If the committee has a director-diversity policy, that policy should be disclosed, as should the method by which the board or committee assesses the effectiveness of such policy. Companies will be permitted to define diversity in a manner that they consider appropriate. Some companies may include differences of viewpoint, professional experience, education, and skill, while others may focus on diversity concepts such as race, gender and national origin.

### **Leadership Structure and Risk Management Process**

The Final Rules require disclosure of a board's leadership structure and why the company believes it is the best structure for the company at the time of the filing. Companies are required to disclose whether and why they have chosen to combine or separate the principal executive officer and board chair positions and whether the company has appointed a lead independent director. If the company has appointed a lead director, it must also disclose his or her role in the leadership of the company.

Companies are also required to disclose the board's role in the company's risk oversight practices. As an example, the SEC suggested that companies disclose whether the board as a whole implements and manages its risk management functions or whether such duties are delegated to a board committee.

### **Form 8 K Disclosure of Shareholder Voting Results**

New Item 5.07 to Form 8-K requires companies to disclose the results of a shareholder vote and to have that information filed within four business days after the meeting at which the vote was held. If definitive voting results are not known by that time, companies are required to file the preliminary voting results within such four business-day period and then file an amended report on Form 8-K within four business days after the final voting results are known.

## Conclusion and Recommended Actions

To comply with the Final Rules, public companies should consider the following action items (many of which were discussed in our prior Client Advisory) in connection with preparing their Annual Report on Form 10-K and proxy statement:

- Compensation committees and management should review their existing compensation policies (for all employees) with respect to:
  - o The company's risk assessment and incentive considerations in the overall structure of a company's compensation policy;
  - o How the company's compensation policies relate to the realization of risks resulting from the actions of employees in both the short term and long term (i.e., the use of claw backs);
  - o The company's policies regarding material adjustments to its compensation policies to address changes in its risk profile;
  - o The extent to which the company monitors its compensation policies to determine whether its risk oversight objectives are being met with respect to incentivizing its employees; and
  - o The company's policy regarding determining the probability of an executive or other employee realizing any condition(s) applicable to the grant of performance awards.
- With respect to stock awards and option grants, companies must:
  - o Recalculate the value for stock awards and option grants in the compensation tables based on the aggregate grant date fair value for all years presented;
  - o With respect to equity awards with performance conditions, implement disclosure controls and procedures to track the grant date fair value based on the probable outcome as well as the maximum value assuming the highest performance conditions; and
  - o Determine whether the new grant date value reporting requirement will affect the company's list of NEOs.
- Review the structure and fees of any consulting arrangements for persons retained by the company for compensation consulting services, including the implementation of disclosure controls and procedures with respect to such services and fees. The board and compensation committee may also want to consider adopting pre approval or monitoring policies with respect to services provided by compensation consultants.
- Boards should evaluate the current board leadership structure (combined or separate CEO and board chair positions) to determine whether the current structure is appropriate for the company, including, if the CEO and Chairman are combined, determining whether the Board should have a lead independent director and his or her role in the leadership of the company.
- Companies should ensure their Director and Officer Questionnaires require the following disclosures for each director:
  - o Principal occupations and employment during the past five years;
  - o Name and principal business of any corporation or other organization in which such occupation and employment were carried on;
  - o Whether such corporation or organization is a parent, subsidiary or other affiliate of the company;
  - o A brief discussion of the specific experience, qualifications, attributes or skills that qualify that person, in light of the company's business and structure, to serve as a director for the company and on any board committees;

- o Any directorships at a public company that he or she has held within the last five years; and
  - o Any legal proceedings he or she has been involved in within the last ten years, with particular attention to be paid to those involving fraud or alleged violations of any securities, commodities, banking or insurance laws and regulations.
- Nominating committees and counsel should consider the specific experiences, qualifications or skills that would qualify a person to become a director.
  - Nominating committees and full boards should discuss the board's policy regarding diversity in identifying director candidates and assess its effectiveness; if the company does not have a diversity policy, the board should consider whether to adopt one.
  - Due to the increase in information required to be disclosed under the Final Rules, registrants should deliver their proxy materials to their directors earlier than usual in 2010, so that each director has additional time to review the materials prior to filing.

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